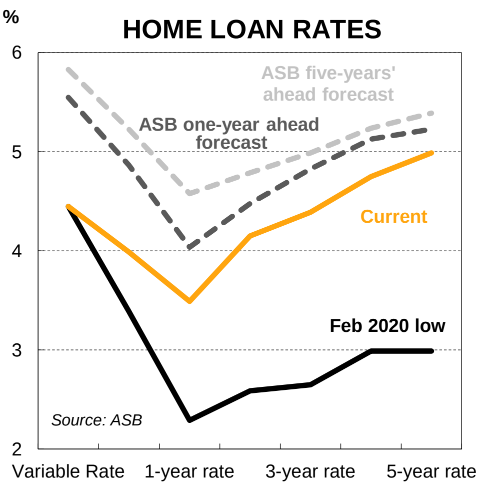
Home Loan Rate Report

04 November 2021

Mortgage rate increases continue

The RBNZ has begun lifting the Official Cash Rate. More RBNZ rate hikes are expected, which has maintained the upward pressure on mortgage rates.



- **The RBNZ began lifting the Official Cash Rate (OCR) in October. More OCR increases are expected at upcoming meetings over the year ahead. Related to this, mortgage rates have lifted, and more increases are expected.**
- We are well past the low point for interest rates. Fixed-term mortgage rates have been lifting over 2021, and our forecasts suggest more increases are coming for mortgage rates over the rest of the year and into 2022. The resilience of the local economy since the initial shock of the pandemic, and confidence in the longer-term outlook, are the reasons we continue to forecast higher interest rates, including mortgages.
- The ASB Economics team thinks every Reserve Bank of New Zealand (RBNZ) meeting should be considered "live" for Official Cash Rate (OCR) increases. However, the arrival of the delta variant of COVID-19 and ongoing Alert Level restrictions are reminders that the situation is fluid and can change quickly.
- ASB is forecasting the RBNZ to lift the OCR back to its pre-pandemic level of 1% by early 2022. We then expect more increases, taking the OCR to a peak of 2.0% by late 2022. This suggests that mortgage interest rates are likely to move higher over this year and next, but an OCR peak of 2% suggests mortgages should settle around historically-low levels.
- Fixing for the lowest-cost shorter terms and subsequently rolling fixed-term mortgages has been a good strategy. However, this approach could be undermined by the prospect of a swift lift in the OCR and mortgage rates over the year ahead, and for those running this strategy, the prospect of higher future rates should be budgeted for.
- Fixing for some of the longer terms provides interest rate certainty for the next few years, but at a higher cost than the cheaper short-term rates. For those who want this longer-term interest rate certainty now, the cost of fixing for two to five years is still very low compared to the past twenty years.

RBNZ delivers the first of a series of rate hikes

The RBNZ's 2020 response to the COVID-19 pandemic had the desired effect of pushing interest rates within the economy significantly lower, including mortgage rates (which dropped to their lowest level in records going back to the 1960s). These super-low interest rates, combined with other monetary measures and the Government's response

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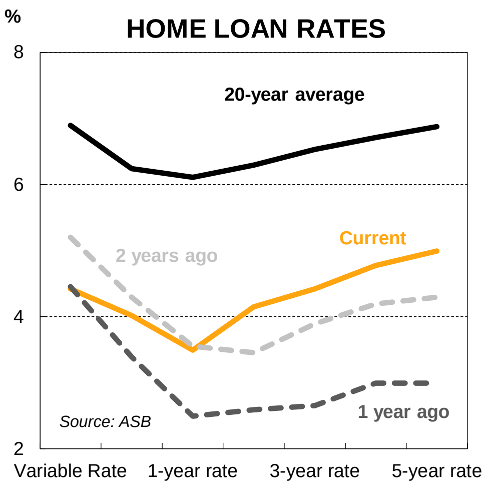
were key to the economic recovery and housing market strength over the past year.

With these developments in mind, ASB economists have been forecasting the RBNZ start unwinding the huge amount of stimulus it put in place last year. This process is now underway. At its October meeting the RBNZ not only lifted the OCR 25bp for the first time in seven years, but also stated that "further removal of monetary policy stimulus is expected over time".

During the pandemic the RBNZ temporarily removed the loan-to-value ratio (LVR) restrictions that were impacting borrowers and borrowing costs. The RBNZ put LVR restrictions back in place this year as the economic recovery gained momentum.



You can find out more from the RBNZ here in a FAQ page and here regarding the developments with LVR restrictions. Debt servicing restrictions are being reviewed by the RBNZ, and were discussed in its latest Financial Stability Report.

What's the outlook for the year ahead?

Clear risks remain to the outlook, particularly with COVID restrictions remaining in place to stem the spread of COVID-19. But our core view is the RBNZ will lift the OCR in 25bp steps to a level of 2% by late 2022. You can read our latest outlook on inflation and the OCR outlook here. Our view is every RBNZ meeting from now on should be considered "live" for an OCR increase.

If the situation changes for the worse, the RBNZ has options to maintain current settings for longer or even lower borrowing costs to support the economy. In addition, fiscal (Government) support will continue. However, if the NZ and global economic outlook continues along the positive path we expect, interest rates are expected to keep lifting as the world gets past the worst of the pandemic.

Continue to budget on higher interest rates

Mortgage rates are past the low point and ASB forecasts suggest rates will continue to lift from current levels over the next five years. For those that require certainty now, fixed terms are still available at very low levels, albeit not as low as they were at the start of this year. We expect the Official Cash Rate to increase several times over the year ahead. In turn, we expect the associated higher wholesale and retail funding costs to push NZ borrowing rates (including mortgages) higher. This process is well underway for fixed-term mortgage rates, which have increased by up to 2% this year for the longer terms.

Prior to the pandemic, the RBNZ had proposed a new regime for bank capital requirements which would have put upward pressure on mortgage rates. The changes were delayed last year as part of the suite of changes the RBNZ made to support the economy. The RBNZ plans to phase in higher capital requirements for banks gradually over the coming years, and that will lead to increases in bank funding costs and, in turn, mortgages. Technical details and the timeline of the changes can be found here, and are considered within our mortgage rate forecasts.

In sum, we think it is prudent for borrowers carrying debt for longer than the next couple of years to budget on mortgage interest rates being higher than they are now. Lenders will likely do budget calculations for loan eligibility using interest rates that are noticeably higher than those currently (i.e., over 6%) being used.

How high could mortgage rates get?

This depends on a host of factors including the RBNZ's Official Cash Rate settings, inflation, and bank funding costs, many of which are difficult to forecast with a high degree of accuracy. Based on the ASB Economics team's expectation that the OCR will peak at 2%, and our assumptions about bank funding costs and inflation forecasts, we expect mortgage interest rates will lift to levels around 0.5% to 1.5% higher than they are now over the next few years, with most fixed rates settling in a 4.5-5.5% range. However, as is often the case, the outlook is far from certain.

Borrowers will be pleased to know we still expect mortgage interest rates to eventually range over the next decade at levels well below the long-run averages of the past 20 years. And borrowers can lock in historically-low longer-term interest rates around 4% if interest rate certainty over a longer period is of the utmost importance (ASB's latest rates are here).

Is it worth breaking to re-set at a lower rate or for a longer term?

ASB can calculate the break costs of a mortgage daily to help with these decisions. There isn't a shortcut to lower mortgage interest rates without incurring a break cost. But breaking a mortgage and resetting at a lower rate or longer term can still be a reasonable strategy for getting interest rate certainty over a longer term at low rates. There are many moving parts in this equation, so take time to work through the numbers, and the pros and cons. A rule of thumb to have in mind is that generally, the bigger the difference between the current mortgage rates and the rate you fixed at in the past, and the longer the term remaining, the bigger the break costs will be.

The RBNZ's loan-to-value ratio (LVR) restrictions are back

The RBNZ first put its LVR restrictions in place back in 2013, and has tweaked them over the subsequent years. In April 2020 the RBNZ temporarily removed the LVR restrictions. That decision ensured the LVR restrictions didn't have an undesired impact on borrowers or lenders from the mortgage deferral scheme implemented in response to the pandemic. RBNZ LVR restrictions are back now, and this is impacting lending practices. Borrowers should discuss their circumstances with their mortgage providers when deciding what to do with their mortgage. Differing levels of equity and risk can have a bearing on credit availability and overall borrowing costs.

Identifying the best strategy

The table on the following page summarises some of the advantages and disadvantages of the different mortgage terms on offer. Floating and short-term fixed rates tend to suit those who prefer the ability to review their mortgage structures frequently (or those who are due to pay off debt shortly). As fixed terms get longer, they are typically preferred for their interest rate certainty.

Everyone wants to secure the "best" deal for their mortgage. Working out what strategy is best is easier said than done given the number of influences impacting on mortgage interest rates, and individual borrower's differing requirements for flexibility and certainty. It's often not as simple as opting for the lowest rate.

Historically the mortgage curve has been "tick-shaped", with 1- to 3-year fixed rates lower than both the variable and 5-year rate. The fixed rates out to the three-year term are below the floating rates at present (except for the ASB Back My Build variable rate). The lowest fixed rates are at the 1-year term at the time of writing, around 1% below the floating rate. The longer-term rates (4-5 years) are typically higher than the shorter-term rates (1-2 years), and that's the case now. The longer-term rates are now above the floating rates on offer. All the latest ASB mortgage rates are available here.

Borrowers can obtain certainty and a significantly lower rate simply by fixing their mortgages rather than having a floating rate mortgage. There is a significant cost of the higher floating interest rate, but some borrowers still prefer the flexibility that comes with floating mortgages. Borrowers could also consider splitting the mortgage into different terms to better suit their preferences for interest rate certainty versus retaining flexibility.

While the future is inherently uncertain, fixing for the longer 2- or 3-year terms are prudent strategies to avoid the expected interest rate increases. It is a trade off of the cost of the higher rate (vs. rolling the cheaper 1-year rate), and interest rate certainty over a longer period.

It's always the case that mortgage rates could dip lower, due to anything from RBNZ actions through to renewed threats to the economic outlook. But right now – even as NZ is forced to adjust to COVID-19's ongoing presence – the risks still appear skewed to higher mortgage rates over time. We suggest all borrowers pick a strategy that suits personal budgets (including a tolerance for changing interest rates) and needs for flexibility, as well as the goal of minimising interest rate costs.

Term	Advantages	Disadvantages	Rate*	Short-term bias	Long-term bias
Floating	Below 10-year average. Fix at any time. Additional principal repayments are easy.	All fixed term rates are cheaper.	4.45	↗	↑
6-month fixed	Cheaper than floating rate. Short-term certainty. Can pay down, alter, or re-fix fairly quickly.	Less flexibility than floating. Exposed quickly to any unexpected near-term rate increases. Other fixed terms are cheaper.	3.99	↗	↑
1-year fixed	Lowest rate currently. Short-term certainty. Can re-fix fairly quickly.	Less protection from near-term interest rate increases.	3.49	↗	↑
18-month fixed	Second lowest rate on offer.	Less of a hedge against interest rate increases if rates go up more than expected over the next few years.	3.89	↗	↑
2-year fixed	Provides interest rate certainty for a reasonable period.	Less of a hedge against interest rate increases if rates go up more than expected over the next few years.	4.15	↗	↑
3-year fixed	Certainty for a relatively low cost. Protection if rates rise quicker than expected.	Potentially more expensive than rolling shorter terms.	4.39	↗	↑
5-year fixed	Certainty at a historically low cost for a long time.	Fixing for short terms expected to be cheaper over next 5 years.	4.99	↗	↑

*** ASB carded rate at time of publishing**

Final thoughts for borrowers

The 'best' mortgage rate is only known in hindsight. Still, with the discussed pros and cons for the various mortgage rates on offer we hope to give you some thoughts to consider the interest rate options that appear most suitable for your personal circumstances.

On top of trying to minimise your interest payments, a good mortgage strategy also needs to take into account your personal cash flows, tolerance for uncertainty, and your ability to deal with changes in future mortgage payments as interest rates change. Everyone's financial circumstances can change, and you need to take this into account too.

It is important to weigh up your own priorities and make the mortgage choice that looks best aligned with your needs. Feel free to phone the ASB Home Loan Line at 0800-100-600 to talk through these issues with the ASB team. Online mortgage calculators are available here. The latest ASB mortgage rates are available here.

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